

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 02-0283

**Adjusted Gross, Supplemental Net, and Unrelated Business Income Tax
For The Years Ending 1996 Through 2000**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

Adjusted Gross and Supplemental Net Income Tax – Unrelated Business Income

Authority: IC 35-45-5-3; IC 6-2.5-5-25; IC 6-2.1-3-23; IC 6-3-2-3.1(a); IC 6-3-1-17(a); IC 6-8.1-5-1; 45 IAC 3.1-1-68.

The taxpayer protests the imposition of adjusted gross and supplemental net income tax on proceeds from illegal gambling machines.

Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-1 & 2

The taxpayer protests the Department's imposition of the ten percent (10%) negligence penalty.

STATEMENT OF FACTS

As a result of an Indiana Excise Police incident report dated December 21, 1994, the Department conducted an income tax audit based upon the Taxpayer's possession of illegal gambling machines discovered at its location. The Taxpayer's representative admitted that some time after the original investigation by the Indiana Excise Police the taxpayer removed the illegal machines from the premises. He also states that the taxpayer began using the illegal machines again in December of 1998.

Adjusted Gross and SNIT – Unrelated Business Income

DISCUSSION

On Tuesday, December 20, 1994 the Indiana State Excise Police conducted an investigation of the taxpayer's premises. The Officers observed three (3) electronic gambling machines in a side room off the barroom area. The taxpayer's administrator admitted that monetary payoffs were being made on the machines at the rate of 10¢ each. The taxpayer's administrator, having been advised of his Miranda rights, stated that he supplied the bartender each day with a start up fund of at least \$1,000 for the machines, and that payoffs are made out of this fund on a daily basis. A weekly ledger sheet was maintained showing monetary amounts paid day by day during the week. A bank bag with \$1, 050 was in a drawer behind the bar and the ledger sheet was found on the back bar.

Under Indiana Code section 35-45-5-3 the machines operated in taxpayer's establishment constitute illegal gambling. Proceeds from illegal gambling are considered unrelated business income and subject to Indiana gross or adjusted gross and supplemental net income tax.

In its protest letter, the taxpayer provided affidavits of its past Governors stating that to the best of their knowledge no illegal gambling machines were located on the premises from May 1, 1995 through April 30, 1998. In December of 1998, the taxpayer's representative states that they once again had illegal gambling machines in their Lodge. Taxpayer argues that the amount of money attributable to the machines was significantly less according to their records. The taxpayer's representative provided the Department with records, which allegedly show the net revenue from the illegal machines. These figures were obtained from the distributor who actually owned the machines (the lodge failed to keep any records). The taxpayer also maintains that the pay out on the machines was eighty percent (80%). The net proceeds were then split between the owner of the machines and the Lodge.

IC 35-45-5-3 provides in pertinent part:

A person who knowingly or intentionally: ... (3) maintains, in a place accessible to the public slot machines, one-ball machines or variants thereof... commits professional gambling, a Class D felony.

The Department and the Internal Revenue Service have held that that illegal gambling is always unrelated to a nonexempt organization's exempt purpose. Exemption from tax for exempt organizations is tied to the gross income tax provisions with respect to exempt organizations. IC 6-2.5-5-25. As provided under IC 6-2.1-3-23, exempt organizations are not entitled to exemption from gross income received by a taxpayer that is derived from an unrelated trade or business, as defined in Section 513 of the Internal Revenue Code. Thus, the Department's determination was guided by I.R.C. § 513, which provides, in part, the following:

...The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Pursuant to IC 6-3-2-3.1(a) and IC 6-3-1-17(a), the Indiana General Assembly has expressly adopted the Code's tax treatment, with respect to Code section 501(c) organizations, for purposes of the Indiana adjusted gross and supplemental income tax analysis. Moreover, the Department's rule 45 IAC 3.1-1-68 defines an unrelated trade or business under the same guidelines as IRC section 513, and the rule also subjects any unrelated business income to the Indiana taxes. Additionally, the rule cites taxpayers to Code sections 511 through 515 for guidance in determining whether income is subject to the taxes.

Pursuant to IC 6-8.1-5-1 if the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department. The proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.

As to whether the Department's audit figures or the taxpayers are correct, comes down to an issue of credibility. The Department used figures based upon the amount of revenue seized by the Indiana State Excise Police in its investigation of taxpayer's Lodge. The taxpayer provides affidavits signed by several past Governors of taxpayer's organization. The affidavits are self serving and weak evidence at best. As for the figures supplied by the taxpayer, the numbers were received from an individual who owned the illegal machines and shared in their illegal profit. The Department will not place any reliance on self-serving information gained from someone engaged in illegal activities.

FINDING

The taxpayer's protest is denied.

II. Tax Administration - Liability for 10% Negligence Penalty

DISCUSSION

The taxpayer protests the Department's imposition of the ten percent (10%) penalty assessment. Indiana Code section 6-8.1-10-2.1 requires a ten percent (10%) penalty to be imposed if the tax deficiency is due to the negligence of the taxpayer. Department regulation 45 IAC 15-11-2 provides guidance in determining if the taxpayer was negligent. 45 IAC 15-11-1(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is also to

be determined on a case-by-case basis according to the facts and circumstances of each taxpayer.

Subsection (d) of IC 6-8.1-10-2.1 allows the penalty to be waived upon a showing that the failure to pay the deficiency was due to reasonable cause. Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish reasonable cause, the taxpayer must show that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed. . . ."

In this instance, the taxpayer has not shown reasonable cause. The taxpayer has not provided to the Department's satisfaction, sufficient justification for why the negligence penalty should be waived.

FINDING

The taxpayer's protest is denied.

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